MERCATUS CENTER
George Mason University
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS
TESTIMONY

WHAT THE EURO CRISIS MEANS FOR TAXPAYERS AND THE U.S. ECONOMY, PART 1
DECEMBER 15, 2011

Anthony B. Sanders
Distinguished Professor of Real Estate Finance, George Mason University, and Senior Scholar, Mercatus Center at George Mason University

United States House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Chairman McHenry, Ranking Member Quigely, and Members of the Subcommittee, thank you for inviting me to testify today. My name is Anthony B. Sanders. I am the Distinguished Professor of Real Estate Finance at George Mason University and senior scholar at the Mercatus Center. I was previously director of asset-backed and mortgage-backed securities research at Deutsche Bank and the co-author (along with Andrew Davidson) of *Securitization* as well as many economic and finance publications.

THE EURO CRISIS

The Eurozone is teetering on collapse, and this has been decades in the making. The cause of their problems is 1) excessive government spending leading to 2) excessive government debt coupled with 3) slow GDP growth.

The core European Union countries (i.e., Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, and Portugal) are expected to have real GDP growth of 1.3% for 2012 and unemployment in 2012 of 9.9% (see Figures 1 and 2). The IMF also produced a longer term real GDP forecast. I have outlined growth for France, Germany, Italy and Spain, and they are all projected to have real GDP growth in 2016 of less than 2% (actually, France is forecast to barely break 2%). At the same time, the European core countries have excessively high government debt-to-GDP ratios (see Figure 3), with Greece at 145% and Italy at 118.4% government debt-to-GDP. The other Eurozone nations have government debt-to-GDP ratios in excess of 80%.

If we look at household and financial debt in addition to government debt, the United Kingdom's (U.K.) debt-to-GDP ratio exceeds 900%. Japan is over 600% and Europe has almost 500% debt-to-GDP. The U.S. is over 300%. In summary, Europe, Japan, and the U.S. are drowning in debt. And a recent article from economists at the European Central Bank (ECB) finds:

> "…we analyse a wide set of 108 countries composed of both developed and emerging and developing countries, using a long time span running from 1970-2008, and employing different proxies for government size… Our results show a significant negative effect of the size of government on growth. …Interestingly, government consumption is consistently detrimental to output growth irrespective of the country sample considered (OECD, emerging and developing countries)."

The European Union will unify, break up, or downsize. But regardless of what option they choose, they still have too much spending and debt relative to their ability to pay for it: GDP growth. But additional debt is not the answer. It is the problem.

The obvious solution is austerity (i.e., a reduction in government spending). But making loans to the ECB or individual countries does not solve the underlying structural problems; it only makes the debt-to-GDP problem even worse. It is simply a short-term solution and actually encourages the Eurozone to delay making the hard decisions.

THE FED'S PREDICAMENT

If Germany and France are successful in creating a fiscally integrated Eurozone, there will likely be less of a rush to purchase U.S. Treasuries (leading Treasury rates to rise). Given that the Fed is already the largest purchaser of U.S. Treasuries, this could be a problem (see Figure 5). China is flat on Treasury purchases, but the U.K. and Japan continue to increase their purchases of Treasuries (see Figure 6). But U.K. and Japanese buying is not enough to pick up the slack from China's flat-lined Treasury purchases.

But what if the Germany/France plan fails? There will likely be a rush to U.S. Treasuries (driving down our yields). The Fed will be watching that possible outcome very closely.

The Fed has been active in the Eurozone bailout starting in 2007, with its Discount Window operations (see Figure 7) that peaked in 2008.[1] The largest Eurozone borrower from the Fed was the failed Belgian bank Dexia. While most of the discount window loans have been repaid, we are still in the dark on the guarantees.

The ECB drew $552 million from the Fed's Dollar Swap Line in the last week of November. These are seven-day dollar swaps at an interest rate of 1.08%.[2] The ECB also borrowed the same amount in an eight-day swap arrangement in the prior week. It begs the question, "How long will the Fed keep its swap line open?" While we cannot see the swap line in real time, the evidence indicates that the basis swap approach has a very short half-life (see Figure 8). The one-year basis swap shows the same temporary impact (see Figure 9).

Recently, the Fed and *Bloomberg Markets Magazine* disagreed about the size of the Fed's intervention (discount window and guarantees).[3] The Bloomberg article said the Fed had committed $7.77 trillion as of March 2009 to rescue the financial system when all guarantees and lending limits were added up. The Fed disagreed and stated that, on any given day, Fed credit from its emergency liquidity programs was never more than about $1.5 trillion. Whether we are looking at "any given day" or the cumulative impact, these are very large numbers, indicating that the Fed is attempting a bailout of the Eurozone.

Yesterday, Fed Chair Bernanke announced that the Fed stands ready to provide further easing based on Eurozone risk.[4] Since the Fed cannot really push down rates much further, the Fed must be contemplating expanding its balance sheet to provide additional liquidity and marginally lowering interest rates. Retirees and people living on fixed incomes will be further harmed by the Fed's reaction to the Eurozone crisis.

On a related issue, the Fed and Treasury should save their bailout tools for the U.S. economy. The GDP boost from additional Federal borrowing is almost zero (see Figure 10). The M1 Money multiplier continues

---

[1] Bradley Keoun and Craig Torres, "Foreign Banks Tapped Fed's Secret Lifeline Most at Crisis Peak," Bloomberg.com, April 1, 2011, http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html.

[2] Dow Jones Newswires, "NY Fed: ECB Draws $552M From Dollar Swap Line In 11/30 Week," *The Wall Street Journal*, December 1, 2011, http://online.wsj.com/article/BT-CO-20111201-714662.html.

[3] Mark Felsenthal, "Bernanke to Hill: Flawed Reporting on Fed Loans," Reuters, December 6, 2011, http://www.reuters.com/article/2011/12/07/us-usa-fed-lending-idUSTRE7B51W420111207.

[4] Scott Lanman and Joshua Zumbrun, "Bernanke Signals Risks From Europe Crisis Keep Fed Ready for More Easing," Bloomberg.com, December 14, 2011, http://www.bloomberg.com/news/2011-12-14/bernanke-signals-risks-from-europe-crisis-keep-fed-ready-for-more-easing.html.

to fall (see Figure 11). When we plot these Federal government intervention measures together (see Figure 10), it shows that intervention has lost effectiveness.

On the Fed side, it is clear that guarantees to the Eurozone could be problematic to U.S. taxpayers. And the swaps with Europe could be costly as well. But since there is little transparency on the Fed's discount window and guarantees, it is difficult to measure taxpayer's exposure to risk.

THE IMF

In addition to Fed operations, the International Monetary Fund (IMF)—of which the U.S. is the largest stakeholder—is also active in the Eurozone bailout. The U.S. has a line of credit approved for an IMF crisis fund in the amount of $100 billion. Given the structural fiscal problems of the Eurozone, there is little likelihood that the Eurozone won't continue to have problems since there is a lack of will to cut government spending and entitlements. So I would expect that the $100 billion line of credit to be used and not paid back.

SUMMARY

The Eurozone's structural problems cannot be solved by low interest loans and guarantees from the Fed and the IMF. In fact, engaging in a bailout of the Eurozone could jeopardize U.S. taxpayers.

The best way to protect U.S. taxpayers is to increase transparency at the Fed, take back the $100 billion line of credit at the IMF, and undertake spending cuts ourselves in order to reduce our deficit and massive debt loan.

APPENDIX: FIGURES

Figure 1. GDP for Selected European Economies

Shaded cells indicate IMF staff estimates

Country	Subject Descriptor	Units	Scale	Country/Series-specific Notes	2009	2010	2011	2012	2013	2014	2015	2016
Austria	Gross domestic product, constant prices	Percent change			-3.888	2.128	3.282	1.640	2.037	2.040	1.899	1.779
Belgium	Gross domestic product, constant prices	Percent change			-2.653	2.106	2.420	1.544	1.739	1.783	1.845	1.833
Cyprus	Gross domestic product, constant prices	Percent change			-1.662	1.041	-0.037	1.000	2.036	2.760	2.701	2.699
Estonia	Gross domestic product, constant prices	Percent change			-13.899	3.105	6.549	4.005	4.156	3.728	3.782	3.804
Finland	Gross domestic product, constant prices	Percent change			-8.227	3.644	3.459	2.245	2.056	2.007	2.014	1.976
France	Gross domestic product, constant prices	Percent change			-2.632	1.384	1.652	1.399	1.867	2.099	2.062	2.081
Germany	Gross domestic product, constant prices	Percent change			-5.078	3.562	2.725	1.273	1.502	1.499	1.295	1.293
Greece	Gross domestic product, constant prices	Percent change			-2.339	-4.354	-5.000	-2.000	1.500	2.300	3.000	3.296
Ireland	Gross domestic product, constant prices	Percent change			-6.995	-0.430	0.363	1.484	2.181	2.845	3.302	3.311
Italy	Gross domestic product, constant prices	Percent change			-5.217	1.296	0.639	0.323	0.540	0.800	1.140	1.240
Luxembourg	Gross domestic product, constant prices	Percent change			-3.639	3.516	3.575	2.741	2.676	2.931	2.902	3.118
Malta	Gross domestic product, constant prices	Percent change			-3.299	3.149	2.450	2.199	2.170	2.327	2.306	2.349
Netherlands	Gross domestic product, constant prices	Percent change			-3.529	1.634	1.630	1.345	1.528	1.648	1.806	1.828
Portugal	Gross domestic product, constant prices	Percent change			-2.507	1.331	-2.159	-1.844	1.190	2.453	2.220	2.000
Slovak Republic	Gross domestic product, constant prices	Percent change			-4.782	4.021	3.250	3.300	4.303	4.240	4.240	4.240
Slovenia	Gross domestic product, constant prices	Percent change			-8.077	1.209	1.900	2.000	2.393	2.307	2.200	2.005
Spain	Gross domestic product, constant prices	Percent change			-3.722	-0.147	0.775	1.123	1.769	1.863	1.945	1.845

Figure 2. Selected European Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

Table 2.2. Selected European Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

(Annual percent change unless noted otherwise)

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Europe	**2.2**	**2.0**	**1.5**	**2.4**	**3.1**	**2.1**	**0.3**	**0.1**	**0.4**	...	...	...
Advanced Europe	**1.8**	**1.6**	**1.3**	**1.9**	**2.8**	**1.7**	**0.8**	**0.8**	**1.0**	**9.4**	**9.2**	**9.1**
Euro Area[4,5]	1.8	1.6	1.1	1.6	2.5	1.5	–0.4	0.1	0.4	10.1	9.9	9.9
Germany	3.6	2.7	1.3	1.2	2.2	1.3	5.7	5.0	4.9	7.1	6.0	6.2
France	1.4	1.7	1.4	1.7	2.1	1.4	–1.7	–2.7	–2.5	9.8	9.5	9.2
Italy	1.3	0.6	0.3	1.6	2.6	1.6	–3.3	–3.5	–3.0	8.4	8.2	8.5
Spain	–0.1	0.8	1.1	2.0	2.9	1.5	–4.6	–3.8	–3.1	20.1	20.7	19.7
Netherlands	1.6	1.6	1.3	0.9	2.5	2.0	7.1	7.5	7.7	4.5	4.2	4.2
Belgium	2.1	2.4	1.5	2.3	3.2	2.0	1.0	0.6	0.9	8.4	7.9	8.1
Austria	2.1	3.3	1.6	1.7	3.2	2.2	2.7	2.8	2.7	4.4	4.1	4.1
Greece	–4.4	–5.0	–2.0	4.7	2.9	1.0	–10.5	–8.4	–6.7	12.5	16.5	18.5
Portugal	1.3	–2.2	–1.8	1.4	3.4	2.1	–9.9	–8.6	–6.4	12.0	12.2	13.4
Finland	3.6	3.5	2.2	1.7	3.1	2.0	3.1	2.5	2.5	8.4	7.8	7.6
Ireland	–0.4	0.4	1.5	–1.6	1.1	0.6	0.5	1.8	1.9	13.6	14.3	13.9
Slovak Republic	4.0	3.3	3.3	0.7	3.6	1.8	–3.5	–1.3	–1.1	14.4	13.4	12.3
Slovenia	1.2	1.9	2.0	1.8	1.8	2.1	–0.8	–1.7	–2.1	7.3	8.2	8.0
Luxembourg	3.5	3.6	2.7	2.3	3.6	1.4	7.8	9.8	10.3	6.2	5.8	6.0
Estonia	3.1	6.5	4.0	2.9	5.1	3.5	3.6	2.4	2.3	16.9	13.5	11.5
Cyprus	1.0	0.0	1.0	2.6	4.0	2.4	–7.7	–7.2	–7.6	6.4	7.4	7.2
Malta	3.1	2.4	2.2	2.0	2.6	2.3	–4.8	–3.8	–4.8	6.9	6.3	6.2
United Kingdom[5]	1.4	1.1	1.6	3.3	4.5	2.4	–3.2	–2.7	–2.3	7.9	7.8	7.8
Sweden	5.7	4.4	3.8	1.9	3.0	2.5	6.3	5.8	5.3	8.4	7.4	6.6
Switzerland	2.7	2.1	1.4	0.7	0.7	0.9	15.8	12.5	10.9	3.6	3.4	3.4
Czech Republic	2.3	2.0	1.8	1.5	1.8	2.0	–3.7	–3.3	–3.4	7.3	6.7	6.6
Norway	0.3	1.7	2.5	2.4	1.7	2.2	12.4	14.0	12.8	3.6	3.6	3.5
Denmark	1.7	1.5	1.5	2.3	3.2	2.4	5.1	6.4	6.4	4.2	4.5	4.4
Iceland	–3.5	2.5	2.5	5.4	4.2	4.5	–10.2	1.9	3.2	8.1	7.1	6.0
Emerging Europe[6]	**4.5**	**4.3**	**2.7**	**5.3**	**5.2**	**4.5**	**–4.6**	**–6.2**	**–5.4**	...	...	...
Turkey	8.9	6.6	2.2	8.6	6.0	6.9	–6.6	–10.3	–7.4	11.9	10.5	10.7
Poland	3.8	3.8	3.0	2.6	4.0	2.8	–4.5	–4.8	–5.1	9.6	9.4	9.2
Romania	–1.3	1.5	3.5	6.1	6.4	4.3	–4.3	–4.5	–4.6	7.6	5.0	4.8
Hungary	1.2	1.8	1.7	4.9	3.7	3.0	2.1	2.0	1.5	11.2	11.3	11.0
Bulgaria	0.2	2.5	3.0	3.0	3.8	2.9	–1.0	1.6	0.6	10.3	10.2	9.5
Serbia	1.0	2.0	3.0	6.2	11.3	4.3	–7.2	–7.7	–8.9	19.6	20.5	20.6
Croatia	–1.2	0.8	1.8	1.0	3.2	2.4	–1.1	–1.8	–2.7	12.2	12.7	12.2
Lithuania	1.3	6.0	3.4	1.2	4.2	2.6	1.8	–1.9	–2.7	17.8	15.5	14.0
Latvia	–0.3	4.0	3.0	–1.2	4.2	2.3	3.6	1.0	–0.5	19.0	16.1	14.5

Figure 3. EU Debt-to-GDP

Hit # <GO> to select an index or <TAB> to change date.

EU Govt Debt as % of GDP Page 1/2

Source Copyright European Communities 1995-2010

#	Name	Ticker	Current Value	Current Date	Previous Value (12/31/09)	Previous Date	Pct Chng
1)	Debt as % of GDP Belgium	EUDB60BE	96.20	12/10	95.90	12/09	.31
2)	Debt as % of GDP Germany	EUDB60DE	83.20	12/10	74.40	12/09	11.83
3)	Debt as % of GDP Spain	EUDB60ES	61.00	12/10	53.80	12/09	13.38
4)	Debt as % of GDP France	EUDB60FR	82.30	12/10	79.00	12/09	4.18
5)	Debt as % of GDP Ireland	EUDB60IE	92.50	12/10	65.20	12/09	41.87
6)	Debt as % of GDP Italy	EUDB60IT	118.40	12/10	115.50	12/09	2.51
7)	Debt as % of GDP Luxembourg	EUDB60LU	19.10	12/10	14.80	12/09	29.05
8)	Debt as % of GDP Netherland	EUDB60NL	62.90	12/10	60.80	12/09	3.45
9)	Debt as % of GDP Austria	EUDB60AT	71.80	12/10	69.50	12/09	3.31
10)	Debt as % of GDP Portugal	EUDB60PT	93.30	12/10	83.00	12/09	12.41
11)	Debt as % of GDP Finland	EUDB60FI	48.30	12/10	43.30	12/09	11.55
12)	Debt as % of GDP Eurozone	EUDBEURO	85.30	12/10	79.80	12/09	6.89
13)	Debt as % of GDP Greece	EUDB60GR	144.90	12/10	129.30	12/09	12.06
14)	Debt as % of GDP EU 15	EUDB6015	60.40	12/07	62.80	12/06	-3.82
15)	Debt as % of GDP Denmark	EUDB60DK	43.70	12/10	41.80	12/09	4.55
16)	Debt as % of GDP Sweden	EUDB60SE	39.70	12/10	42.70	12/09	-7.03
17)	Debt as % of GDP UK	EUDB60UK	79.90	12/10	69.60	12/09	14.80
18)	Debt as % of GDP Slovakia	EUDBSK	41.00	12/10	35.50	12/09	15.49
19)	Debt as % of GDP Slovenia	EUDBSI	38.80	12/10	35.30	12/09	9.92
20)	Debt as % of GDP Poland	EUDBPL	54.90	12/10	50.90	12/09	7.86

Figure 4. Global Debt as Percentage of GDP

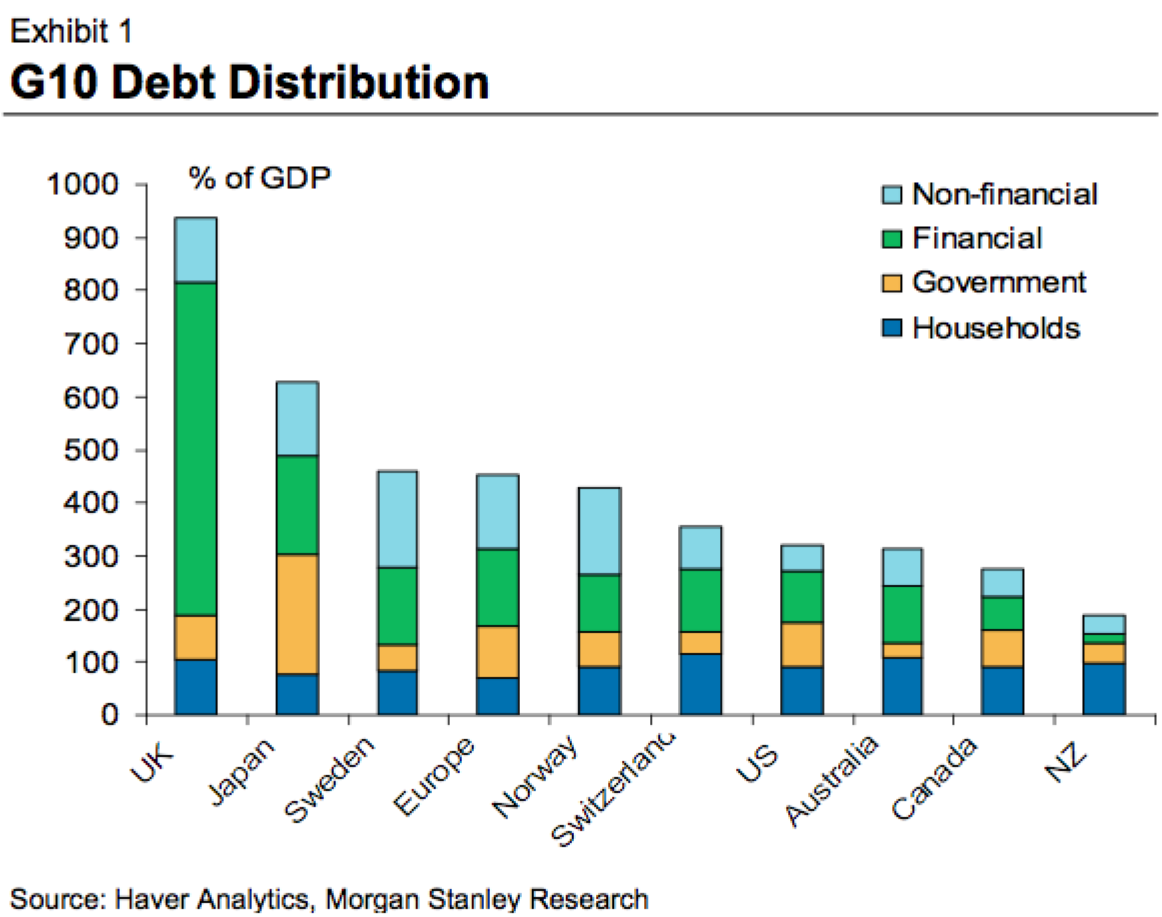

Figure 5. The Fed's Balance Sheet

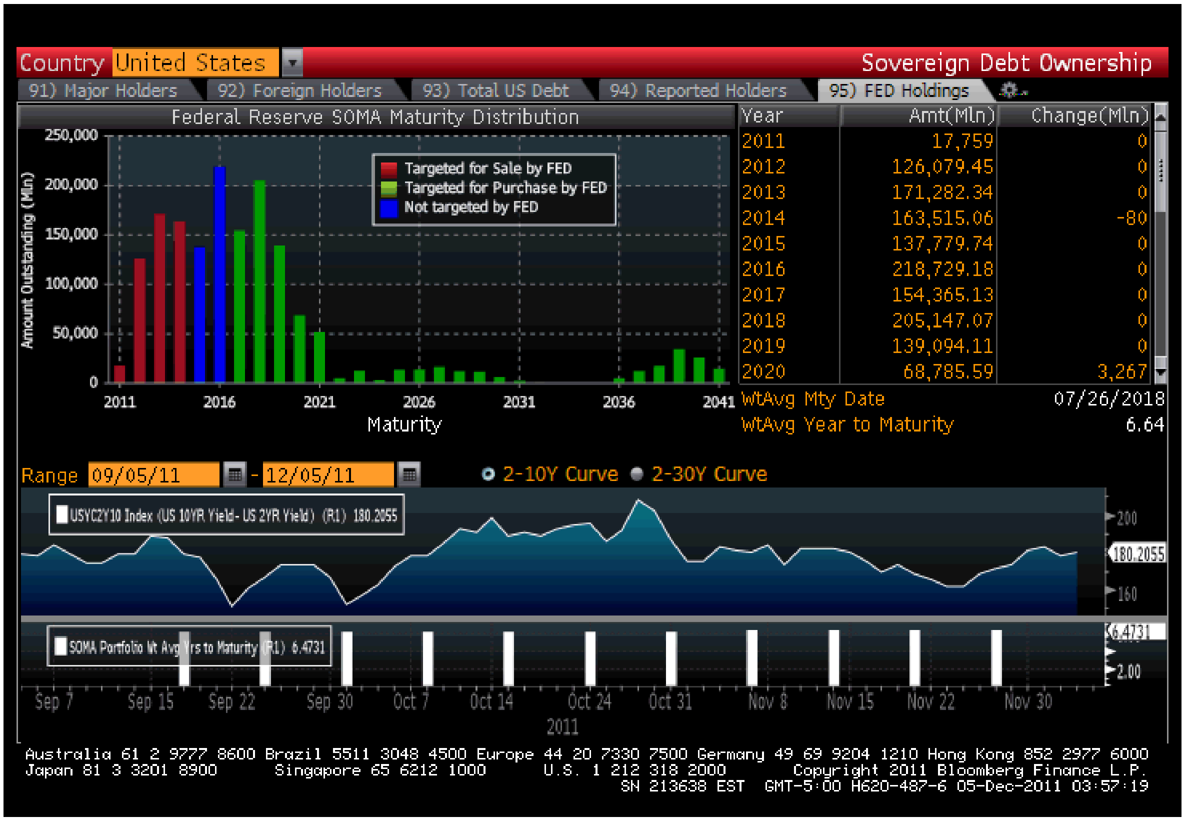

Figure 6. Who Owns Our Treasury Debt?

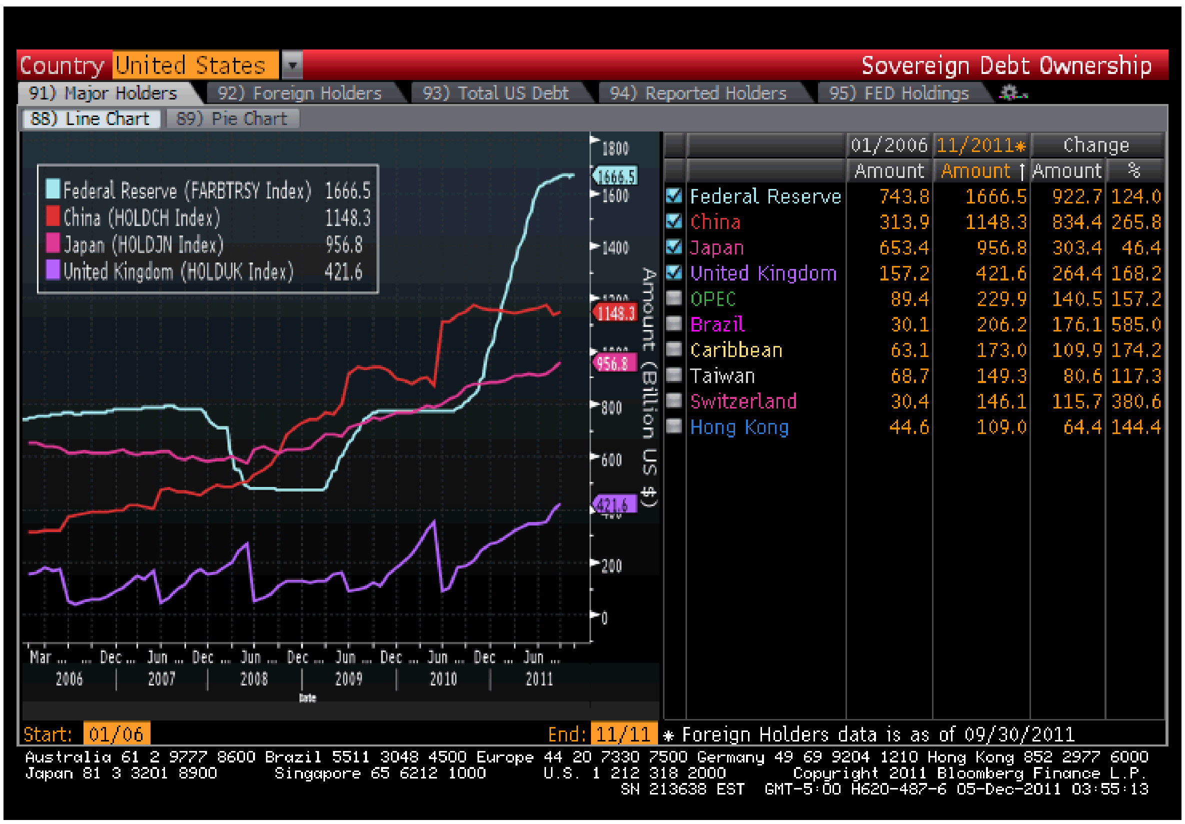

Figure 7. The Fed’s Discount Window Operations

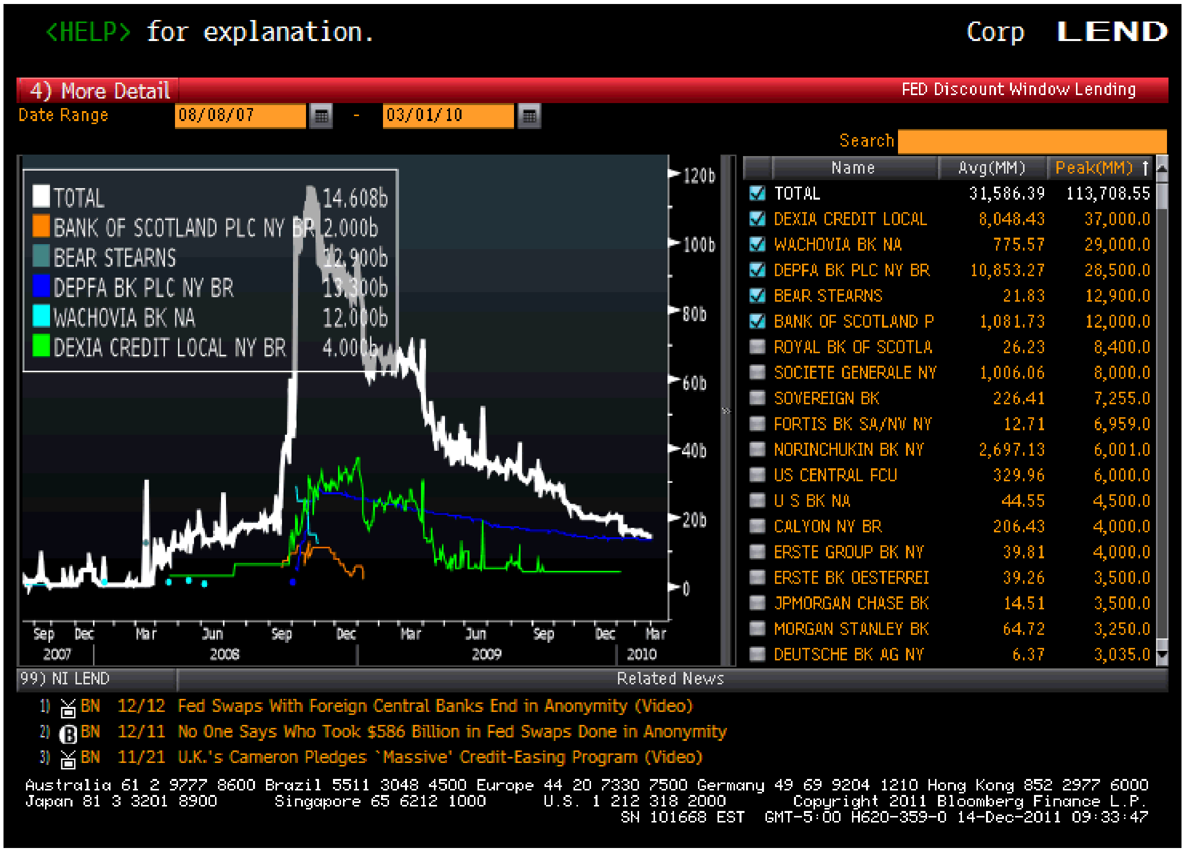

Figure 8. 3-month Basis Swap Dropping Back to November 30 Levels

Figure 9. One-year Basis Swaps

Figure 11. Marginal Impact of Additional Federal Debt on Real GDP

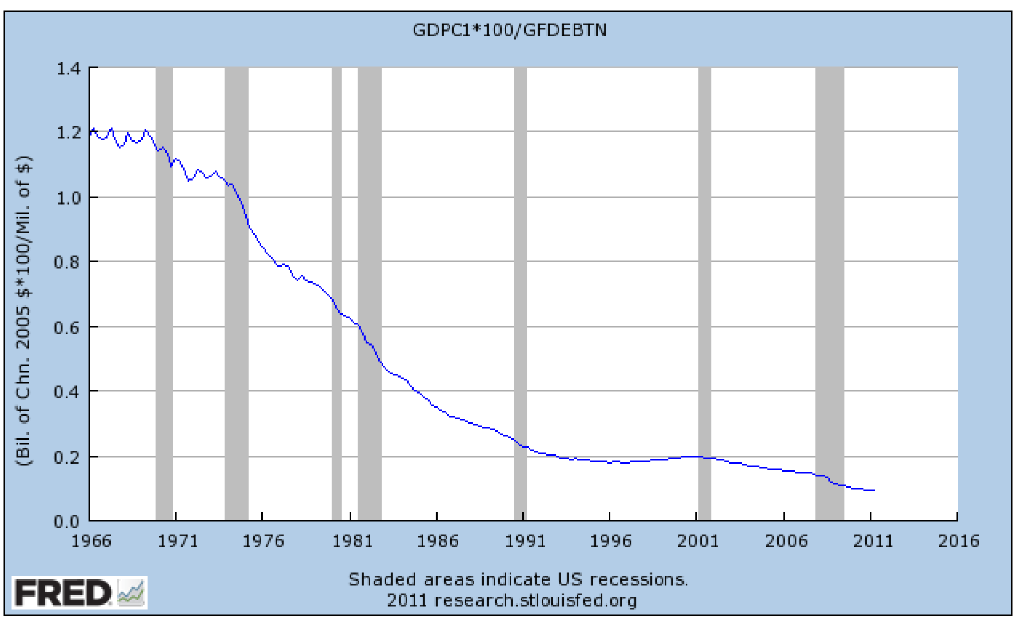

Figure 10. Marginal Impact of Additional Federal Debt on Real GDP and M1 Money Mulitplier